

Houston Business

A Perspective on the Houston Economy

The shifting market for health care has again hindered the Texas Medical Center, and budget cuts have brought reverses to the Johnson Space Center. Nationwide growth and a highly profitable energy sector are now driving the Houston economy.

Houston Again Shares State's Economic Growth

Over the past year, Houston's economy has slowly picked up steam, and local growth favorably compares with that of the rest of Texas for the first time since the end of the Persian Gulf war.

Figure 1 shows the growth rate of wage and salary employment in Houston and Texas, calculated over the previous 12 months for each month since January 1994. In Houston, this 12-month growth rate briefly slipped under 2 percent last autumn but has since accelerated beyond 3 percent. Meanwhile, statewide job growth fell from near 4 percent last year to a still-respectable 3.4 percent in June.

Strong job growth in Houston led Texas out of a statewide recession between 1987 and 1991, but the local economy slowed to a standstill in 1992 with the collapse of natural gas prices and with widespread restructuring and downsizing by Houston's largest energy firms. Slow growth continued in 1993 as several federal policy proposals struck hard at Houston's most important economic institutions: the Btu tax would have hurt refining and petrochemicals on the ship channel; proposed health care reform raised concern about the future of the Texas Medical Center; and a presidential review of the space station project hurt investment in the Clear Lake area.

The resolution of these policy issues seemed to set the stage for renewed growth in 1994 and 1995. However, the shifting market for health care has again hindered the Texas Medical Center, and budget cuts have brought reverses to the Johnson Space Center. Nationwide growth and a highly profitable energy sector are now driving the Houston economy.

GOOD NEWS FROM THE NATIONAL ECONOMY AND ENERGY

Strong economic expansion throughout the United States added to Houston's job growth in 1994. The national recovery from a shallow recession began in March 1991 but ran counter to economic expansions' typical pattern of starting fast and then slowing. This recovery was slow to heat up, and real gross product grew only 1.6 percent per year from 1990 to 1993. Employment growth seemed nonexistent. In 1994, however, the pot finally began to boil, as gross domestic product grew to 4 percent and then climbed to an annual rate of 5.1 percent by year's end. The nation added 3.3 million new jobs in 1994.

The national economy is always a positive source of growth for Houston, although the benefits spill into the city later and with less impact than in other parts of Texas. This is not surprising with 60 percent of the local economic base still tied to energy. Even in energy markets, however, a strong U.S. economy works to hold up the price of crude oil, oil products, natural gas and petrochemicals. For the 40 percent of Houston's economy not tied to energy, companies such as Compaq, BFI or American General, strong national growth brings direct benefits.

Houston's oil and natural gas companies also have been a big plus in 1995. For the second quarter, the *Wall Street Journal* reported that profits increased by 98 percent for integrated oil companies, 130 percent for secondary oils and

62 percent for oil field equipment and service companies. How could this be? After all, the price of natural gas has averaged 50 cents less per thousand cubic feet than 1994 levels, and the Baker Hughes rig count is running 8 percent behind 1994 levels. The short answer is the surprising resilience of domestic upstream activity despite low energy prices, improved drilling activity overseas and very strong performance by downstream refining and chemicals.

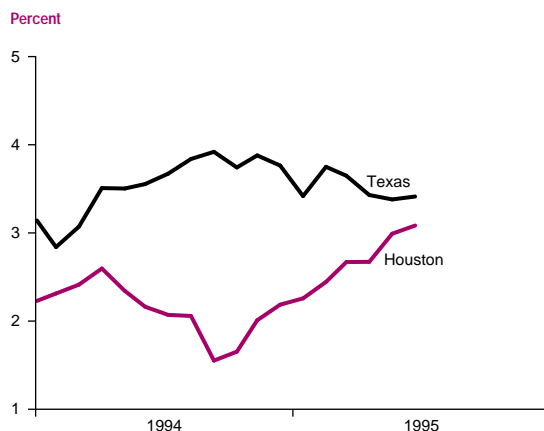
Natural gas drilling remains the mainstay of U.S. exploration activity, as it made a normal seasonal recovery in 1995, even if the level of activity lagged last year. Operators insist that natural gas is the fuel of the future and that current low prices contain a large seasonal component, a hangover from the warm winter. Further, technological advances have decreased the number of dry holes and cut the cost of drilling, making exploration profitable at much lower energy prices than in the past. Meanwhile, better oil prices have encouraged a spurt of drilling activity overseas, helping make overseas drilling a key factor in strong profits among local oil service and machinery companies.

Also important to oil service companies is the high level of activity in the Gulf of Mexico. Recent improvement in drilling activity should continue throughout 1995. The Gulf's traditional role as the nation's major natural gas-producing region drives most current drilling, but interest is growing in deep-water oil development that will entail huge investments offshore. Further, new technology makes it possible to explore regions invisible to conventional seismic measurements; in several years, we will find out what lies below large, unexplored areas of the Gulf.

Downstream, however, is where a major source of recent oil company profits lies. Although refiners did well in the second quarter after a very poor start in 1995, petrochemicals have consistently produced big profits for the past year.

Big profits in any industry are usually followed by big investments, and this has been the case for petrochemicals. In recent years, substantial overcapacity has plagued the industry, and the number of new construction projects undertaken along the Texas and Louisiana Gulf Coast fell steadily as the chemical investment boom of the late 1980s ended. However, the downward trend in the number of new hydrocarbon processing projects turned around last year, and more than 170 new projects have been

Figure 1
Employment Growth Rates in Houston and Texas
(Year-Over-Year Annual Rates, Seasonally Adjusted)



SOURCE OF PRIMARY DATA: Texas Employment Commission.

announced along the Texas and Louisiana Gulf Coast in 1994 and 1995.

It is difficult to overestimate the economic impact of petrochemical construction along the Gulf Coast. The capital budgets of the big oil companies for domestic refining and petrochemical projects have averaged \$6 billion per year since 1993, down from a recent peak of \$7.6 billion in 1992. Based on the number of active projects under way, at least 40 to 50 percent of this money is spent on the Gulf Coast.

Figure 2 shows total construction employment in 11 metropolitan areas along the Gulf Coast between Corpus Christi and Baton Rouge and compares it with that in 15 metropolitan areas to the north. These 15 areas are in North Texas (east of Abilene and Austin) and northern Louisiana. Over the 25 years from 1969 to 1994, the average level of total employment in these areas was virtually the same as in the Gulf Coast region—3.4 million. Although total job gains came faster in the northern cities over 25 years—113.9 percent vs. 94.8 percent—the Gulf Coast's construction employment levels averaged 44.8 percent higher. Ongoing design, construction and maintenance of hydrocarbon processing facilities on the Gulf Coast explain much of this difference. As these projects grow in number, the Houston and Gulf Coast economy can improve rapidly.

BAD NEWS FROM MEDICINE AND SPACE

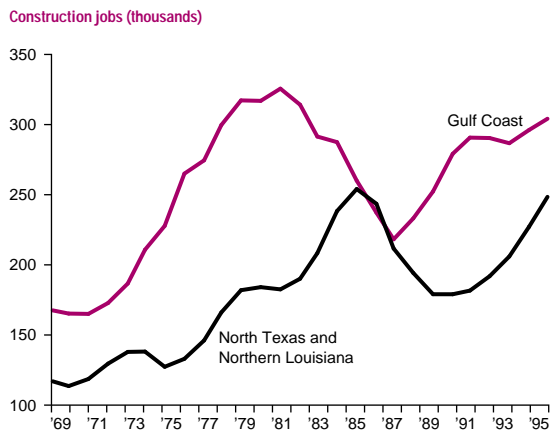
Early this year, renewed growth seemed possible for the Johnson Space Center (JSC) and the Texas Medical Center (TMC). The space station project survived federal budget cuts, and government-led health care reform died. But both institutions have since met new problems and are not contributing to Houston's current expansion.

The TMC's pressures to control medical costs continue to mount. Now, pressures stem from employers and insurance companies instead of government initiatives.

These pressures take two forms. First, primary care physicians now treat many patients who might have seen a specialist before. The TMC, as the pinnacle of specialized care in the Southwest, finds itself getting fewer referrals for patients in Victoria, Beaumont or Oklahoma City. Second, a strong trend favoring outpatient care over hospitalization cuts into TMC revenues even if overall patient loads remain unchanged.

Figure 2

Construction Employment on the Gulf Coast Compared with North Texas and Northern Louisiana Metropolitan Areas



NOTE: 1995 data are annualized based on first-half results.

SOURCE: Bureau of Economic Analysis, Bureau of Labor Statistics.

TMC employment peaked at 54,000 in 1993 but probably slipped under 50,000 in 1994 and continues to decline.

The decision in 1994 to build the space station, even if under the constraints of a lower budget, seemed to settle JSC's role in Clear Lake for some time to come. This apparent certainty proved short-lived, however, with an administrative mandate to cut \$8 billion from the NASA budget over the next five years. JSC-related spending in Houston had already fallen from a 1992 peak of \$1.6 billion to \$1.3 billion in 1994. The additional budget cuts will cost JSC at least 3,250 civil service and contractor jobs in coming years. As with the medical center, JSC is probably lost as a source of significant growth for Houston for several years at least.

OUTLOOK

Growth in Houston is a matter of getting our economic ducks lined up, of getting several big growth centers to work positively for the city at the same time. While the Johnson Space Center and Texas Medical Center may have moved to the sidelines for now, oil and natural gas have returned to the forefront. For a strong second half in 1995, Houston needs a rebound of the national economy and continued profits upstream and downstream. With even modest luck, Houston should maintain job growth between 3 and 4 percent for the rest of this year, for a net gain of 60,000 jobs in 1995.

Houston's economy is growing moderately, with energy sectors showing surprising resilience to low energy prices. Refiners and petrochemical producers saw their markets cool down in recent weeks, and both look to an improved U.S. economy to help product prices. The new home market has turned around sharply; apartment and warehouse construction is strong; and office markets show flat rents and slow improvement in occupancy.

RETAIL AND AUTO SALES

Local retail chains continue to report weak same-store sales. The smaller regional chains, often found outside the biggest malls and competing with discounters, seem to be hurt most. Large department stores and bigger discounters are matching last year's sales but falling short of meeting any plans to exceed last year's results.

Auto and truck sales in June and July rose 2 percent over the same period last year, and Houston is enjoying a good summer sales season. On a year-to-date basis, auto sales are up 1 percent for the first seven months of 1995.

ENERGY PRICES AND DRILLING ACTIVITY

The price of crude oil fell from near \$19 to \$17 in mid-June, as OPEC briefly threatened to increase production to recapture lost market share. Strong demand for crude and oil products has slowly pulled price back to \$18 dollars per barrel. Natural gas prices have continued to weaken for most of the summer. Prices at the Henry Hub were near \$1.65 per thousand cubic feet in early June and fell to \$1.35 in July despite heavy demand for electricity during the heat wave across the Midwest and East Coast. Although storage now lags year-ago levels and hurricanes have threatened production in the Gulf of Mexico, prices have improved to only \$1.50.

Oil service and machinery companies continue to report good business conditions. They point to offshore activity and foreign demand as the key sources of new business. Domestic drilling for natural gas remains brisk despite low natural gas prices. Although improved oil prices in 1995 have fueled gains in overseas drilling

activity, this summer brought the lowest level of *domestic* oil-directed drilling since World War II.

REFINING AND PETROCHEMICALS

Wholesale gasoline prices have dropped sharply over the summer, falling faster than oil prices and putting refinery profit margins under substantial pressure. Gasoline prices rebounded slightly in late July thanks to demand that was 4 percent higher than last year and very low inventory levels.

Petrochemical demand has slowed slightly, and inventories have returned to levels that are normal or higher. Some recent price increases have been rescinded, but prices have flattened out at levels that remain extremely profitable. Companies are concerned that prices may be poised for a drop if the two big markets for plastics—housing and auto markets—do not improve soon.

CONSTRUCTION AND REAL ESTATE

Through midyear, building permits for the city of Houston are up 6.8 percent over 1994. New residential construction, led by a substantial increase in apartment building, is up 43 percent. Nonresidential construction is up 1 percent. Small and medium-sized contractors in Houston remain busy and are building backlogs.

Houston's new home sales have finally responded to falling interest rates, rising 9 percent in the second quarter compared with the same period last year. In contrast, existing home sales in the second quarter were off 7 percent. However, this comparison must be qualified: last summer, sales of existing homes reached some of the highest levels in Houston history.

Suburban office space was absorbed to the north and northwest of downtown Houston, and the citywide vacancy rate continued its slow trend toward improvement. Top quality office space is leasing well but largely at the expense of inferior office space and without higher rental rates. As rental rates for warehouse space have increased and as vacancies have fallen, several speculative warehouse projects have been announced. Again, these are suburban projects to the northwest and southwest of Houston.

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